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Schroders FundFocus

Schroder ISF* Strategic Bond

We caught up with Bob Jolly to talk about the challenges of bond market investing in the coming year, and the ways that Schroder ISF Strategic Bond can generate returns in a variety of difficult market conditions.

February 2015

Bob, can you tell us a little about Schroder ISF Strategic Bond and its approach?
The strategy's core characteristic is its flexibility. We aim to provide our investors with a total return by investing in a very wide range of assets; from conventional government or corporate bonds to asset backed securities and floating rate notes. Another crucial part of our capacity to generate returns is in foreign exchange, which is extremely valuable in diversifying the type of risks the portfolio is exposed to. Schroder ISF Strategic Bond uses risk rotation, rather than sector rotation, to determine its construction. The variety of tools available to us means that the fund can perform in markets that prove challenging for more conventional bond funds.

What are the main advantages of taking this approach?
The key advantage is that we can think very differently about the way the portfolio is positioned. When I mentioned before that the strategy can prosper in a wider range of markets than conventional bond funds, it is because of the way we think of risk and add it to the portfolio. Rather than rotating our exposure to different market sectors, which is a traditional approach, we focus on risk rotation. This means that we are less exposed to wider market movements, or market 'beta'. By extension, this means we do not need a specific bond market to rise to make our investors money.

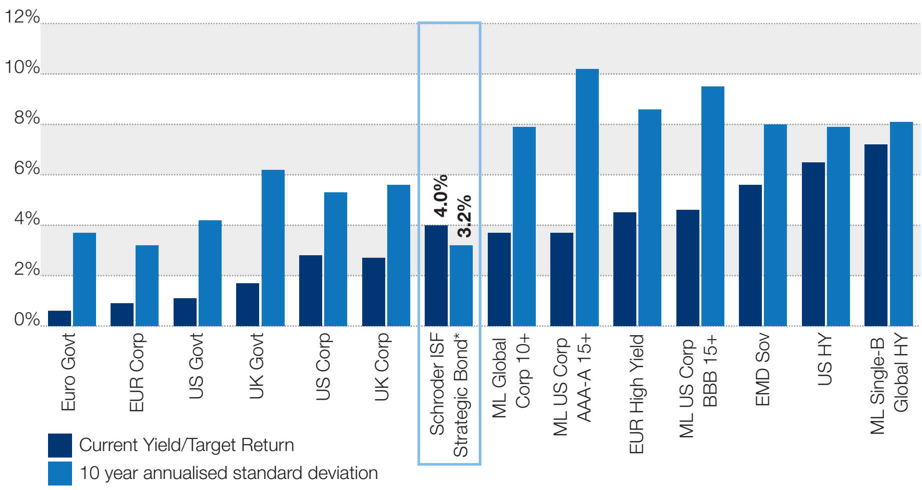
How do you typically arrive at an investment decision?
We're lucky at Schroders to have a comprehensive research facility. It's something the company takes pride in, and having such an extensive and dedicated resource is a real advantage. It means we can use a truly global macro view to access a diverse set of 'alpha sources'. These are the various channels of risk exposure we use when pursuing total returns. We use a themes based approach; taking a detailed picture of the world's economies and global markets, identifying the themes that we see developing amidst the fundamental data, and we implement trades which will capitalise on these dynamics.

Where do the themes come from?
We produce a strategic 'roadmap' on a quarterly basis, which identifies the themes. Each active theme is expected to remain valid for between three months and a year. These are distilled from our views on global growth, global monetary and economic policy and global inflation. Once we have three to five key strategic themes, we find trade ideas to implement the view for each, which will also incorporate existing market sentiment and positioning. These views and positions are reviewed in daily, weekly and monthly meetings, with tactical adjustments where necessary.

So once you've established which themes to implement, how are they reflected?
We will always construct a portfolio with diversified risk, but one with clearly defined drivers. In conventional beta-led strategies, in which decisions are based on areas of the market the manager favours or dislikes, it is almost impossible to insulate the portfolio from market swings. The aim for a beta strategy manager is to reduce any participation in a market fall, or to outperform the market if it rallies. Diversifying this type of strategy with a higher number of positions does not necessarily reduce risk. In Schroder ISF Strategic Bond, we will identify our themes through the research process and construct specific trades to express each one. We make sure that the trade expressions are diversified by alpha source and time horizon. Finally, we make sure that each trade has a catalyst identified for both entry and exit before it is initiated, and as I mentioned before, we will monitor any active positions constantly.

What are the alpha sources?
The alpha sources can be thought of as the portfolio's total return generators. We don't rely on just one. Instead of rotating our exposure through market sectors, we can rotate into different active return strategies. These are typically duration, country, curve, inflation,

Risk vs. reward



*Schroder International Selection Fund is referred to as Schroder ISF throughout this document. Source: Schroders, Bloomberg, as at 30 January 2015. Annualised standard deviation for Schroder ISF Strategic Bond is based on weekly data since Bob Jolly took over management of the strategy in 2011.

credit and currency. These reflect our views on foreign exchange moves, the relative strength of different global economies, our expectations for interest rate moves, and of course, inflation rising or falling.

How long do you typically hold a trade once it has made its way through the investment decision process?
I feel it is very important to highlight that there is no predetermined life span for our trades. We focus on what we know, not what we think. The market rarely reacts rationally to new developments and this can lead to decisions which are not backed up by underlying data. We monitor each one of our positions constantly through a live risk monitoring system which allows us to see both specific positions and how the entire portfolio is moving on a rolling basis.

Can you give an example?
One example could be our current view of the Federal Reserve's (Fed) monetary policy stance. The Fed's comments on potential rate hikes – as economic data for the US improves – have been very moderate for some time. This means that the market currently expects the Fed's first rate 'normalisation' steps to be made later than we do. We think that the market is underestimating the proximity of the Fed tightening policy. As such, the portfolio is positioned for both a rise in US interest rates, and a stronger US dollar. These trades respectively fall into our 'duration' and 'currency' alpha sources.

How do you see the environment for bond investors developing in the coming year?
As we've just touched on, we expect that the US economy – which improved ahead of expectations in 2014 – will continue to outstrip the rest of the world for the next twelve months. The decline in the oil price in the second half of 2014 has of course weighed on short-term inflation expectations, but the longer-term effect in our view is that lower oil prices will act as a significant booster for US growth. This will arm the Fed with the capacity to raise rates faster and more sharply than the market expects. The UK has also improved markedly, and although the economy lacks the vigour of the US, we expect that excess capacity will continue to be exhausted in the coming year. There are uncertainties clouding the horizon, but we again believe that the Bank of England will move to raise rates in 2015, and see this happening earlier than the market is currently pricing in.

It will be an interesting year for the eurozone, now that the European Central Bank has announced a truly impactful quantitative easing programme. It plans to inject €1.1 trillion into the region over the next 18 months. Yields have already compressed to historic lows across the risk spectrum in the eurozone, but while capital gains might be challenging to achieve, support for valuations should remain high for a long time – potentially well beyond our one year horizon.

Emerging markets could endure a more difficult year, depending on the way these economies react to a Fed rate hike. It could be quite drastic, and we certainly see volatility increasing in 2015. However, 'emerging markets' is not a homogenous term; incorporating some countries with very weak fundamentals and other which are much more stable. We expect there to be some investment opportunities amid periods of market stress.

> “We focus on what we know, not what we think, because the market rarely reacts rationally to new developments and this can lead to decisions which are not backed up”

Performance Summary – periods to 31 December 2014

Performance in USD %	Year-to-date	1 year	3 years	5 years	10 years
Schroder ISF* Strategic Bond A Acc	2.0	2.0	10.4	15.8	42.4
Benchmark	0.2	0.2	0.9	1.6	21.1

Source: Schroders, A Acc class, NAV to NAV basis, net income reinvested. The Fund is not benchmark constrained, but for reference purposes presents its performance against the LIBOR 3 Months Index. With effect from 01/04/2011 Schroder ISF Strategic Bond changed its investment objective.

Fund Manager Biography

Bob Jolly joined Schroders' Fixed Income Team in September 2011 as Head of Global Macro. Prior to joining Schroders, Bob worked for UBS Global Asset Management where his more recent responsibilities were Head of Currency, UK Fixed Income and Global Sovereign. Prior to UBS, Bob spent two years with SEI investments developing customised solutions for institutional pension fund clients. The majority of Bob's investment career was spent at Gartmore Investment Management where he held various positions, the most recent being Head of Fixed Income Portfolio Construction. Bob is a CFA Charterholder.